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Making Tax Digital: Evidence in support of the statements made to the House of Lords Economic Affairs Committee on 6 February 2017

Richard Murphy

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City Political Economy Research Centre
cityperc@city.ac.uk / @cityperc

City, University of London
Northampton Square
London EC1V 0HB
United Kingdom

Making Tax Digital

Evidence in support of the statements made to the House of Lords Economic Affairs Committee by

Richard Murphy FCA
Professor of Practice in International Political Economy, City, University of London

CITY UNIVERSITY OF LONDON EST 1894

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Summary

1. The evidence that follows addresses four issues concerning HM Revenue & Customs' Making Tax Digital ('MTD') programme. These concern the number of taxpayers likely to be impacted by MTD; the costs and benefits of MTD, MTD's likely impact on the tax gap and the broader implications of MTD for the credibility of the UK's tax and small business accounting systems.

Number of taxpayers impacted by MTD

2. The number of self-employed taxpayers likely to be impacted by MTD is likely to be seriously understated by HMRC. This is for three reasons.

3. Firstly, HMRC do not appear to have included in their estimate of those impacted by MTD those taxpayers who will have to keep MTD records to prove that they do not need to submit MTD returns. Given that non-submission when required to do so is bound to have penalties attached to it and the threshold has been set at a level on the boundaries of which a considerable number of self-employed people are trading this might mean that at least 750,000 more self-employed people than HMRC estimate might have to keep MTD records simply to prove that they do not need to do so if they are to avoid a risk of penalty. This substantially increases the cost of MTD and at the same time makes self-employment of more marginal benefit to many than it already is.

4. Secondly, the HMRC estimate of taxpayers impacted by MTD appears to be based solely on the number of taxpayers currently submitting tax returns. As a result they exclude the number of people evading their responsibilities, but those taxpayers should be included in any estimate of the total number of people impacted if an estimate of the proper use of the system is to be made. I estimate that maybe 500,000 additional self-employed people are excluded from the HMRC estimate of people impacted by MTD as a result.

5. Thirdly, and economically erroneously, HMRC suggest that landlords are self-employed people for MTD purposes. Evidence from FOI data and other sources suggests that HMRC may not have an accurate view of the number of landlords in the UK and so, as a result, of how many may be impacted by MTD. Available evidence suggests that their estimate of those impacted by MTD may be low because they have insufficient data to make an accurate or consistent estimate. It is also likely that have failed to include in their estimate those landlords who will have to keep MTD records to prove that they do not need to submit MTD returns.

6. In addition to these issues, my research has shown that HMRC has a very poor track record in securing tax returns from the UK's limited companies. Based on the last available data it failed to secure corporation tax returns from 80.4% of the companies it requested them from. On average from 2007-08 to 2011-12, which is the last year for which data is available, just 1,004,000 companies declared to HMRC that they had taxable income in the UK. This was despite 1,176,000 companies being PAYE or VAT registered on average during the period in question. This data would appear to suggest that HMRC's current estimate of 1.6 million companies being impacted by MTD might be high, but as the evidence in this report suggests, reasonable extrapolation and allowance for non-compliance, including updating for the number of companies now in existence, suggests that HMRC's estimate may be 340,000 short of the number of companies that might now be expected to be impacted by MTD. How HMRC proposes to secure data from companies when so many have failed to deliver data in the past is an issue that MTD does not appear to have addressed as yet.

7. In summary this section suggests that maybe 1,250,000 more self-employed people, an unknown number of landlords and maybe 340,000 more companies might be impacted

by MTD than HMRC suggest to be the case. This also suggests that their cost estimates for MTD may be seriously understated.

MTD revenue and cost estimates

8. HMRC's estimates of revenues to be secured by MTD assume that approximately ten percent of all errors and mistakes resulting from a failure to exercise reasonable care will be eliminated by MTD. This in itself is open to doubt, but HMRC would appear to themselves be making an error when making their estimate of recovery by assuming that all errors and mistakes resulting from a failure to exercise readable care arise in the tax returns of those to whom MTD will apply when less than 51% of the tax gap as a whole is attributable to these taxpayers according to their own data. If only those errors and mistakes due to a failure to take reasonable care that can fairly be attributed to this part of the taxpayer population are taken into account then the base value of such errors that HMRC should use when undertaking their calculations would halve to £4.4 billion, with resulting revenues likely to also halve as a result.

9. HMRC has also appeared to confuse the nature of the two categories of error they believe need to be considered when estimating the recovery to be made from MTD. Whilst it is reasonable for HMRC to think, at least in principle, that mistakes arising as a result of failure to take due care may be reduced by MTD those attributable to error which arise despite the taxpayer having sought to inform themselves of the proper course of action to take are very unlikely to be changed by MTD, however many ‘nudges’ might be built into software at HMRC’s request (and much to user irritation). This again reduces the size of the tax gap that HMRC should consider to be subject to change as a result of the introduction of MTD. Just £2.8 billion of the tax gap may result from SME failure to take care, but even this figure is unlikely to be seriously impacted by MTD when more than two thirds of all taxpayers are already advised by agents. These taxpayers already have much lower mistake rates than unrepresented taxpayers. Only the unrepresented are likely to see a serious change in their mistake rate as a result. Each of these taxpayers would have to increase their tax payment by £570 a year to justify HMRC estimate of tax recovery: this level of recovery is considered very unlikely to happen based on evidence from the National Audit Office.

10. In practice this rate of recovery is also questionable because the assumption that the error rate will fall by 10% appears overly optimistic. Evidence from the NAO suggests that error rates in tax returns submitted by professional agents is approximately 15% whilst that in tax returns submitted by the taxpayer themselves may be 35-40%. 65% of all tax returns were submitted by agents when the NAO undertook their review, which was in 2010. At present I have not found data to update these estimates and assume they are still the best available. It is very optimistic to think that the error rate in professionally submitted tax returns will reduce significantly as a result of MTD. There is

clearly room for improvement in the tax returns of the self-employed. Whether that improvement will arise is open to question for six reasons.

11. First, MTD will require submission of data at short notice and to very tight deadlines when compared to current tax return filing deadlines. This is almost bound to increase involuntary error rates.

12. Second, MTD deadlines will encourage the use of estimates on occasion: the pressure to avoid penalties may well induce such behaviour to avoid fines or other impositions.

13. Third, professional firms will find that their work has to be undertaken in short periods of intensive activity around MTD submission deadlines and this is, again, bound to increase error rates.

14. Fourth, imposition of new systems will increase errors for a considerable period due to unfamiliarity.

15. Fifth, the correction of errors is usually more difficult in software packages than it is in manually based on spreadsheet accounting systems, and the process of error correction has to both be learned and then used correctly. There is no guarantee that this will happen. There is a significant chance that the use of software by those unfamiliar with it and who are reluctant and enforced users of it will actually increase error rates.

16. Sixth, the imposition of what will seem to the vast majority of MTD submitters of a wholly unnecessary administrative burden from which they will not perceive any benefit is unlikely to induce a compliant mindset.

17. The chance of HMRC seeing any fall in the error rate in professionally submitted MTD returns (estimated to be at least two thirds of the total) is very small in that case. The savings HMRC estimate in the remaining taxpayer population considerably exceed the average monetary value of errors the NAO found in this population when they undertook their work. Again, as a result the forecast savings are very unlikely to arise. As a result I estimate that savings may not amount to £1,055 million year as HMRC imply for 2020-21 but may ne negligible instead, especially when new causes of error arising are taken into account.

18. With regard to MTD compliance costs, my work has concentrated on ongoing rather than transition costs as I believe that this is the more important issue. HMRC have stated that they believe that taxpayers will benefit by £100 million a year as a result of the introduction of MTD. It is worth noting that this sum amounts to just £17 per MTD submitter. There is however strong evidence to suggest that these savings will not arise.

19. I have estimated that 20% of all MTD submitters will require new software licences to comply with its requirements. Having allowed for the lowest cost I can find for this software some £67 million of HMRC's total annual taxpayer cost estimate of £170

million will be expended in this way. This leaves £103 million in HMRC's estimate to cover the cost of submitting the 23.6 million MTD returns HMRC believe will be required each year. That means that HMRC believe that they will impose a cost of £4.36 each. Assuming the task can be undertaken by a person paid national minimum wage (which may not be a reasonable assumption to make) this suggests HMRC think that an MTD return will take no more than 35 minutes to complete. Given the considerable range of tasks involved, which I have listed in an appendix to the evidence submitted, this is a wholly unreasonable estimate. I suggest that for even a small sole trader the time required might be at least 3.5 hours, or half a day. This means small business owners will dedicate two days a year to MTD submissions, or approximately one per cent of the total working time of an average self-employed person. The average earnings of a self-employed person in the UK are £10,800, or roughly the national minimum wage given the average hours worked. On this basis I estimate that the absolute minimum costs of compliance in terms of a taxpayers own time (based on profit foregone) amount to £108 per annum for each landlord and self-employed person. I assume the cost would be double that in the case of a company, at a minimum, because of the extra complexity that their accounting tends to involve. On the basis of these estimates I expect that the minimum additional costs to business of MTD submission will be £810 million, to which must be added software costs of £67 million, already noted, making a total of £877 million in all, some £707 million more than HMRC suggest.

20. However, it is likely that the two thirds of taxpayers who now submit tax returns professionally will ask their agents to prepare their MTD submissions. Assuming a fair charge of no more than £20 per hour plus VAT for those involved, and assuming an accountant is a little more efficient than the taxpayer (which may not be true if any queries arise) then I estimate that this will cost at least £300 a year. Ad hoc checking with accountants suggested that this a fair estimate for unincorporated business. Estimates of £600 pa for MTD compliance have been provided for companies. Assuming that all landlords self-submit their MTD returns as their returns are likely to be the simplest, and that 65% of the self-employed use an agent to submit MTD returns and 78% of companies might do so (based on evidence from the NAO on the use of agents to prepare existing tax returns) then the estimated cost of MTD submission would be £1.714 billion a year. Of this sum £1.412 billion would be paid to agents, which may explain why HMRC's MTD consultations won broad approval from those representing that community. This estimate assumes that those taxpayers using an agent have no additional compliance costs that they incur other than the fee paid to the agent: that, of course, is very unlikely to be true, meaning that this cost estimate is likely to be understated. Additional software costs must also be added to this estimate, increasing it to £1,777 million, or approximately £1.8 billion, a year. This estimate is the one I make as the most likely minimum cost of MTD to taxpayers. £1.8 billion is almost exactly fifty per cent of the cost of running HMRC a year.

21. I cannot identify any likely ancillary benefits rising to businesses from MTD. As a matter of fact, almost all small businesses of the size that MTD will impact most can be managed on the basis of heuristic key performance indicators that do not require the

owner to prepare full accounts to establish very accurate indicators of business performance for management purposes. As such few businesses will secure any real benefit from MTD, not least because few small business owners have any real understanding of the accounts that are prepared by agents on their behalf at present. In addition existing tax payment methods do also provide most of them with entirely acceptable bases for budgeting likely tax payments. As a result I believe that HMRC's claim that business will benefit from MTD is not justified.

22. Although not studied in any detail, HMRC's estimate for transition costs also appear to be underestimated.

23. It is notable that HMRC has provided no estimate of its own costs of implementing MTD. Since it is inconceivable that there will be none this is a serious omission on their part that needs urgent correction.

MTD and the tax gap

24. HMRC's estimate of the benefits arising to it from MTD are, in its view, solely attributable to a reduction in one aspect of the tax gap. As already noted, there are good reasons for thinking that these benefits will not arise. The attached evidence suggests numerous reasons why instead MTD might increase errors and mistakes due to failure to take reasonable care in accounts. Most of these relate to increased time pressure to undertake work at minimum cost against tight submissions for MTD filing, with a consequent and inevitable fall in accounting quality.

25. This report makes clear that MTD does not attempt to tackle tax gaps arising from the hidden economy, tax evasion, criminal activity and late payment. Based on evidence noted in the report it is suggested that HMRC may understate the scale of the SME tax gap by almost £23 billion a year, and notes that taxpayer alienation induced by MTD may increase this sum.

26. Anecdotal evidence acquired whilst preparing this report also suggests many small business owners may either close or shrink the size of their businesses as a result of MTD, both actions being motivated by a desire to avoid compliance with its requirements. This will impose a real cost on the UK economy which no tax system should do.

27. The report suggests that instead of introducing MTD, which imposes substantial additional costs on that part of the UK small business community that is currently making efforts to be tax compliant, HMRC should instead expend more effort on identifying those who should be taxed but are not at present.

28. In this context it is appropriate to note that Adam Smith identified four maxims with regard to the management of taxation in 1776 in The Wealth of Nations[ii]. In summary these are that tax should be equitable, certain, convenient and efficient. There is no

evidence at all that MTD is equitable, convenient or efficient. The only thing certain about it is that it will impose considerable additional cost on taxpayers. It is very unlikely to close any tax gap.

Conclusions

29. HMRC said in January 2017 that its objectives for MTD were:

    a. To bring the tax system into line with what businesses and individuals now expect from other online service providers: a modern digital experience;
    b. To help businesses get their tax and NICs right first time. That will reduce the likelihood of errors, giving businesses greater certainty;
    c. To reduce anticipated errors by around 10% of error on an ongoing basis, and give businesses a clearer view of their tax position in-year, enabling them to plan to meet their tax obligations at minimum cost and minimum disruption.

30. Based on the evidence in this submission:

    a. Taxpayers do not expect HMRC to deal with them digitally. Instead most, including the majority with significant tax liabilities, rely upon agents to do this for them. HMRC are then seeking to supply an experience that taxpayers do not desire;
    b. The evidence is that by far the best way to reduce the error rate in tax return submissions is to encourage taxpayers to engage agents. Error rates more than halve in that case in the existing self-assessment system. It is very hard to believe that error rates amongst those who use professional advisers will be much changed as a result of MTD. There are very good reasons to think that error rates will increase amongst all taxpayers as a result of MTD;
    c. Most businesses have more than adequate notice of likely tax liabilities under existing self-assessment arrangements.

    On the basis of this evidence it is likely that HMRC will not achieve its stated objectives for MTD.

31. The evidence in this report also suggest that MTD will:

    a. Potentially impose inappropriate and potentially seriously misleading accounting methods on taxpayers that may be seriously harmful to their business interests to suit the requirements of HMRC. Business failures as a result of the use of inappropriate accounting data are likely to increase as a result;
    b. Potentially threaten the cash flows and so viability of small businesses in the UK;
    c. Threaten the credibility of small business accounting in the UK;
    d. Potentially harm UK economic performance as a result.

It is hard to think of a policy more antithetical to the culture of enterprise in the UK than MTD as HMRC propose to impose it.

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Full report

Background to MTD

32. Making Tax Digital ('MTD') is an HM Revenue & Customs ('HMRC') project with originally stated intentions of[iii] making better use of data; managing tax in real time; providing each taxpayer with a single tax account and permitting HMRC to interact digitally with customers.

33. MTD has been subject to very rapid development for a project of such significance. It was announced 2015[iv]; was subject to a range of consultations in 2016[v] and was most recently subject to announcements in late January 2017[vi]. It has been subject to serious criticism by the Treasury Select Committee[vii] whose work is drawn to the attention of the Economics Affairs Committee but is otherwise not drawn upon unless explicitly referred to. The Public Accounts Committee has also expressed its concerns about the HMRC digitisation programme[viii].

34. It was originally suggested that MTD should embrace the following themes to embrace its intentions, and these became the basis on which consultations took place:

    a. Bringing business tax into the digital age[ix];
    b. Simplifying tax for unincorporated businesses[x];
    c. Using a cash basis for unincorporated property businesses[xi];
    d. Making tax administration digital[xii];
    e. Making tax payment on voluntary pay as you go basis[xiii];
    f. Transforming the tax system through better use of information[xiv].

35. In January 2017 the government appeared to restate its objectives for MTD and said that these were now[xv]:

    a. To bring the tax system into line with what businesses and individuals now expect from other online service providers: a modern digital experience;
    b. To help businesses get their tax and NICs right first time. That will reduce the likelihood of errors, giving businesses greater certainty;
    c. To reduce anticipated errors by around 10% of error on an ongoing basis, and give businesses a clearer view of their tax position in-year, enabling them to plan to meet their tax obligations at minimum cost and minimum disruption.

36. At the same time it was stated that these requirements will apply to businesses' Income Tax and Class 4 NICs obligations from April 2018, VAT from April 2019 and CT from April 2020.

37. It was also stated that MTD will apply to all businesses and landlords with annual turnover exceeding £10,000[xvi].

38. The financial benefits of MTD to HM Treasury are forecast to amount to £10 million in tax year 2018-19, £310 million in 2019-20 and £625 million in 2020-21. These savings are stated to arise solely as a result of reducing errors through record keeping[xvii]. It was claimed in January 2017 that the overall benefit from MTD will be at least £2 billion by the end of tax year 2020-21[xviii]. The implication is that in the tax year 2020-21 MTD will contribute additional revenues of at least £1,055 billion.

39. In their latest tax gap estimates HMRC suggest that failure to take reasonable care results in a tax loss of £5.5 billion per annum whilst errors cost £3.2 billion a year[xix].

40. HMRC suggest that failure to take reasonable care results from a customer's carelessness and/or negligence in adequately recording their transactions and/or in preparing their tax returns. They say that judgments of 'reasonable care' should consider and reflect a customer's knowledge, abilities and circumstances. HMRC define errors as mistakes made in preparing tax calculations, completing returns or in supplying other relevant information, despite the customer taking reasonable care[xx].

41. When providing their estimate of the latest tax gap HMRC suggest that only £18.3 billion of the total tax gap of £36 billion is attributable to the small and medium sized business sector to which MTD is almost wholly applicable. They do not make suggestion as to what proportion of errors and failure to take reasonable care is attributable to this sector, but it would seem unlikely that such mistakes are solely to be found in this area and are instead likely to be evenly distributed across all sectors.

42. HMRC says the number of businesses impacted by MTD are as follows[xxi]:

    a. Approximately 3.3 million self-employed individuals. However, HMRC state that this includes around 900,000 landlords who are not conventionally considered to be self-employed (for economically justified reason). As such this number has to be considered in two parts: 2.4 million of these people are self-employed and 900,000 are landlords;
    b. 1.6 million companies;
    c. 400,000 ordinary partnerships;
    d. About 600,000 businesses with income from different sources (for example, both self-employment and property).

    As a result it is suggested that 5.9 million taxpayers will be impacted by MTD of which at 3.4 million involve self-employed people.

43. The costs and savings resulting from MTD to taxpayers have been estimated as follows in January 2017[xxii]:

Current breakdown of admin burden costs and savings (all £m)

Profile (£m)	2017 to 2018	2018 to 2019	2019 to 2020	2020 to 2021	2021 to 2022	2022 to 2023
Steady-state costs	-	£100	£170	£170	£170	£170
Admin burden savings	-	-£40	-£200	-£270	-£270	-£270
Transitional costs (one-off)	£100	£500	£350	£30	-	-
Net impact	£100	£570	£320	-£70	-£100	-£100

44. HMRC imply that the transitional costs to business (which they estimate will amount to £980 million) will include the costs of:

   a. Time spent by a business familiarising itself with new digital tools and quarterly submission of information;
   b. Purchase of new apps and upgrading existing software;
   c. A small minority of businesses needing to purchase new hardware or upgrade existing hardware;
   d. Additional accountancy/agents costs.

45. HMRC's estimate of the steady state costs of MTD, which they suggest will amount to £170 million a year, include the cost of software licenses and the actual cost of submitting quarterly updates to HMRC.

46. HMRC's estimate of admin burden savings is noted later in this submission.

Issues to be covered in this submission

47. This submission primarily addresses four issues:

   a. Whether HMRC has appropriately estimated the number of businesses to be impacted by MTD;
   b. Whether MTD will have the costs and benefits that HMRC suggest might arise from it;
   c. Whether the scale of the tax gap is likely to be impacted by MTD and in what way, with reasons stated;
   d. Whether MTD will provide taxpayers with any benefits over and above the existing self-assessment tax system.

48. As a result of these restrictions in scope this submission will not consider:

a. Whether MTD is technically feasible, or not;
b. Whether MTD is deliverable in the time frame indicated by HMRC.

49. Ancillary observations will be supplied on the following issues as a consequence of the primary observations made:

a. The implications for accounting of MTD;
b. The implications of MTD for taxation policy;
c. The implications of MTD for taxpayer relationships;
d. The implied priorities of HMRC that MTD reveals.

The number of business impacted by MTD

50. HMRC's estimate of the number of businesses to be impacted by MTD are noted above Para 42). This submission suggests that those estimates may be seriously wrong.

51. HMRC imply in their submission that at most 3.4 million self-employed people may be impacted by MTD (Para 42). HMRC's own most recent data on the number of people declaring self-employed income in the UK suggests that that in 2013-14 tax year 5.62 million people did so[xxiii]. Those declaring net incomes for tax purposes of more than £5,000 totaled 3.35 million people, or the approximate number of self-employed people HMRC suggest may be impacted by MTD. These people do, then, represent 59.6% of the total declared self-employed population. There are, however, two reasons why it is very unlikely that this number represents the total impacted by MTD.

52. Firstly, it is widely accepted that tax evasion is likely to be more commonplace amongst the self-employed than amongst some other parts of the taxpaying community. Estimates of the number of undeclared self-employed people in the country might vary and are bound the be approximate. If, however, error rates found by the National Audit Office[xxiv] of between 15 per cent and 40 per cent of total liabilities reported on tax returns actually submitted is replicated in the population of those liable to make returns then it is likely that at least 20% of those liable to make a return do not actually do so, suggesting non-submission by maybe 1.1 million people a year, some of whom would undoubtedly be required to participate in MTD. Assuming that those not declaring have lower than average incomes it is still possible that 500,000 people required to submit MTD returns miss the system altogether on this basis. Further research on the issue would be useful.

53. Secondly, it is not true that a person can ignore MTD if their business has a turnover below the reporting threshold. With that level being set so low (£10,000 pa), and with it almost certain to be the case that, as with VAT, penalties will be imposed for not submitting when required to do so, a significant number of the 2.2 million self-employed taxpayers who appear to currently be exempted from the MTD system will, in practice, have to keep MTD records to ensure that they do not, inadvertently, exceed the

required turnover threshold on an ongoing basis, and so avoid penalties. If anyone earning more than £2,000 net from self-employment was at risk of registration for MTD in this way at least 750,000 more people might need to keep MTD records on a precautionary basis than HMRC currently estimate.

54. Putting these two estimates together suggests that 1.25 million more people than HMRC estimate might need to keep MTD records, albeit that some might not do so. HMRC's cost estimates for the self-employed would appear to be understated as a result. It is also important to note that as many of the costs of MTD will be relatively fixed for those on lower levels of self-employed income the benefits of self-employment will be considerably more marginal for many than it already is at present. Alternatively, and as will be noted later, the attractions of working in the shadow economy will increase considerably.

55. The HMRC estimate of the number of taxpayers involved in MTD noted in Para 42 implies that 900,000 landlords without another source of reportable income and 600,000 landlords who also have a self-employment may be impacted by MTD. One issue HMRC have not so far resolved is how a person with multiple sources of MTD income might make disclosure: the question of how multiple reports a quarter is not addressed in the documents published by MRC to date. This is not the focus of concern at this moment, however: the number of landlords required to make declaration is. HMRC suggested in the most recent data that they have published[xxv], which relates to the tax year 2013-14, that there are 1.75 million people with taxable rental income arising in the UK. Of these only 405,000 enjoy net income exceeding £10,000 pa, but gross incomes are obviously higher. These numbers are, however, surprisingly low: HMRC FOI reply reference 1715/14 dated 12 May 2014 suggested that at least 2,085,000 people had declared rental income on tax returns in 2012-13 tax year, on a rising trend per annum. It was admitted that this data was incomplete for those submitting short form tax returns and that this total understated the likely number of people with such income because an unknown number of people were having rental income assessed through PAYE coding notices without a tax return being required whilst an unknown further number of people also had holiday rental and rent-a-room income. In the circumstances the accuracy of HMRC's estimate of taxpayers required to comply with MTD must be in doubt: it does not appear that comprehensive data to prepare estimates exists. They must be considered very approximate as a result. In addition, the caveat noted with regard to self-employed people must be taken into account: as a matter of fact landlords who do not appear to require MTD registration may actually have to keep such records if there is a risk that their gross income may exceed £10,000 per annum (which is a figure much less predictable when a cash rather than accruals basis of accounting is taken into consideration and when short term letting with a variable risk of voids is taken into account). HMRC's estimate of the number of landlords to be involved in MTD is, therefore, open to question and may underestimate the actual number who will need to keep records.

56. HMRC's estimate of the number of companies impacted by MTD is also open to doubt. My research has revealed HMRC's serious weaknesses when collecting data from UK registered companies[xxvi]. What that data shows is that on average there were 2,663,700 companies in existence in the UK form 2007 to 2012 (the number has risen considerably since then). Over that same period an average of 1,916,800 companies were asked to make corporation tax returns each year. Of course, some companies were at any point in time too new for the requirement to submit a return to exist, but on average 384,000 companies a year were formed each year during the period in question, leaving approximately 363,000 companies a year that were not asked for corporation tax returns because it was claimed that they were dormant, although evidence to provide that this was the case was likely to be scant. Of the average 1,916,800 companies that were asked to submit corporation tax returns only 1,540,800 a year did so on average (80.4% compliance rate). On average over this period of the 1,540,800 companies submitting corporation tax returns just 1,004,000 declared that they had trading income (63.5% of those submitting, but 37.7% of the total number of companies in existence). This was despite the fact that other HMRC data showed that on average 1,176,000 companies were VAT or PAYE registered each year during this period. 172,000 companies a year that were trading did not, then, submit corporation tax returns providing information as to their accounting and profits to HMRC each year. As, however, the number of companies trading and not VAT registered must exceed the number trading and VAT registered this underestimates the number of companies not declaring their trading to HMRC, potentially by a considerable margin. The error rate cannot be known for sure: there is no reason think though that it might not be the same number again, implying that at least 1,348,000 companies may have been trading on average (50.6% of the total register in the period under review).

57. There were 3,833,469 companies in the UK in December 2016[xxvii]. Extrapolating the above data would imply that 1,445,000 companies might declare they have trading income on corporation tax returns at present and that maybe 1,940,000 might actually be trading. In this case the HMRC estimate that just 1.6 million companies should be impacted by MTD looks to be low and that maybe 340,000 more companies should really be impacted than HMRC believe to be the case.

58. In summary this section suggests that maybe 1,250,000 more self-employed people, an unknown number of landlords and maybe 340,000 more companies might be impacted by MTD than HMRC suggest to be the case.

59. The implication of this finding is that it would seem that HMRC currently hold insufficient information on those in the tax base to suggest radical reform to the ways in which they might be required to declare their tax liabilities. Efforts to raise tax revenue might in that case be better expended in identifying who are taxable but who do not declare that fact. In addition ensuring that those not paying at present might be a much better use of time than trying to eliminate the errors made by those already attempting to be tax compliant might make in the tax returns that they do actually submit.

The costs and benefits of MTD

60. The benefits arising to HM Treasury noted in Para 38 arise, in its opinion (as certified by the Office for Budget Responsibility on two occasions), from a reduction in errors in taxpayer record keeping, whether arising as a result of failure to take reasonable care (costing £5.5. billion pa) or error arising despite the tax payer taking reasonable care (costing£3.2 billion pa).

61. As noted in paragraph 41, there is no reason to think that all these errors in record keeping arise in the SME sector to which MTD applies. 50.8% of the total tax gap arises in this sector. It is entirely reasonable to assume that such errors are spread right across the tax paying population. In that case the total loss to these causes would be approximately £2.8 billion pa from failure to take reasonable care and £1.6 billion pa from error, or £4.4 billion in all.

62. It is not logical to presume that the rate of error (as defined by HMRC) in taxpayer submissions will fall as a result of MTD. Error is explicitly stated to arise despite the taxpayer having taken reasonable care. In that case the mistake is honest likely to relate to genuine misunderstanding rather than, for example, an inability to add up. These mistakes are very likely to continue under MTD. No amount of 'nudging' built into software is likely to change them. As evidence, the National Audit Office found in 2010 when reviewing tax returns for 2004-05 that the average tax liability declared on a tax return by a professional tax agent was 15% less than the true sum likely to be owing[xxviii]. This was considerably better than the average under-declaration of 35-40% on the tax returns of those who were not represented, but suggests that error is not eliminated even when the return is prepared by someone who should know the tax system. There is then no reason to think that MTD will change this in any material way. As such SME errors are likely to continue to run at a rate of £1.6 billion pa.

63. This then means that any recovery of tax will have to result from a reduction of the loss arising from failure to take reasonable care amongst those in the SME and landlord community. As noted in Para 38 it is estimated that by 2020-21 this saving will amount to £1,055 million pa. This implies that 37.7% of errors will be eliminated in this sector as a result of the use of software to make MTD submissions.

64. This estimate appears to be optimistic for a number of reasons. First of all, many of the taxpayers in question will already be using accounting software and there is unlikely to be significant change in it as a result of its adaptation for MTD. Secondly, many of those not using software now will already be having their tax returns submitted by professional tax agents. In 2010 the National Audit Office estimated that 65 per cent of self-assessed income tax returns and 78 per cent of corporation tax returns were already submitted by professional agents[xxix]. There is no reason to think that these ratios have changed significantly since then. These tax returns suffered error rates substantially lower than those for unrepresented taxpayers, as might be expected. It is unlikely that MTD will significantly change the error rate in these cases. In that case, and using

HMRC's estimates of the numbers of business involved, at most 1,850,000 of the taxpayers subject to MTD must see their compliance rate improve as a result using the system. The required recovery per taxpayer to achieve the £1,055 million HMRC estimate of additional tax paid will be £570 for each of these taxpayers. As the National Audit Office noted in 2010, in 2004-05 the average underpayment on each unrepresented taxpayers' tax return was £350. That figure may have been expected to rise since then, although because the trend in average self-employed earnings has been markedly downward since that time this is not likely[xxx]. In that case the chance that the estimated sum to be recovered will actually be collected as a result of reductions in errors and failure to take reasonable care looks to be very low.

65. Turning to costs and savings to taxpayers HMRC's estimates are, again, open to question. For example, steady state costs of MTD are assumed to be £170 million a year. As noted in paragraph 43, these costs include the cost of software licenses and the actual cost of submitting quarterly updates to HMRC. It is reasonable to think that most of those submitting their tax returns through professional agents might already use accounting software of some sort: most agents encourage this. That leaves, as the previous paragraph noted, 1,850,000 taxpayers who might need to adopt new software. It is reasonable to expect some of them will be using software already, even if the error rates noted in their tax returns might imply otherwise. For the sake of argument suppose half, or 925,000, will need new software. Quickbooks for the self-employed is available at a cost of £6 a month. Xero, which is another popular package, costs £10 a month. I will use the lower figure. That implies 925,000 people will spend £72 a year on software, which is a cost they had not previously incurred. This amounts to £67 million a year, leaving £103 million to cover the costs of submitting MTD returns. HMRC estimate that 5.9 million taxpayers will make such returns four times a year, meaning that an annual total of 23.6 million will be required. If HMRC are correct in thinking that these will cost no more than £103 million in total each will, on average, cost no more than £4.36 to submit. The minimum wage from April 2017 will be £7.50 an hour[xxxi]. This implies that an MTD return can be submitted by a person on that wage rate in 35 minutes. Of course, many of those working on such submissions will be paid more than this: they will have to work somewhat more quickly. On this basis the HMRC estimate of costs to be incurred appears to be seriously understated.

66. The reality is that even in the case of a small business the tasks involved in submitting each MTD return will be considerable. I note in an appendix to this evidence the likely additional tasks a business may need to undertake each quarter to comply with MTD and suggest that in a simple business these may take at least half a day a quarter: in larger ones they may take very much longer. Assuming that approximately two days a year will, then, be expended on this task in the most basic of cases and that average earnings of a self-employed person are £10,800 per annum[xxxii] the forgone opportunity that this represents is a cost of approximately 1% of the annual income of such businesses, or £108 a year for the most basic of entities. Assuming, quite reasonably, that company accounting is more complicated, and doubling this allowance in their case for that reason, the total cost arising as a result would be £810 million a year based on

HMRC estimates of the number of entities involved. It should be noted that this is before any overhead costs of any sort that might reasonably be attributed to this task are allocated to it. It could quite fairly be stated as a result that this estimate seriously under-estimates the true cost of MTD submissions. Software costs of £63 million must be added to this sum, suggesting absolute minimum compliance costs of £877 million per annum, £707 million more than HMRC estimate.

67. To check the reasonable of this figure I have sought indication from some accountants as to their likely charges for filing MTD returns. Estimates of about £300 a year for sole traders and £600 for companies appear to be commonplace. The trader would still, of course, incur other costs within the business on top of these costs. Assuming a fair charge of no more than £20 per hour plus VAT for those involved, and assuming an accountant is a little more efficient than the taxpayer (which may not be true if any queries arise) these figures appear to be entirely reasonable, and assume staff employed at quite modest rates of pay are engaged in this tasks. This estimate does, however, suggest that the £810 million estimate of costs is substantially understated. Assuming that all landlords self-submit their MTD returns as their returns are likely to be the simplest, and that 65% of the self-employed use an agent to submit and 78% of companies might do so (based on evidence from he NAO on the use of agents to prepare existing tax returns) then the estimated cost of MTD submission would be £1,714 million a year. Of this sum £1,412 million would be paid to agents, which may explain why HMRC's MTD consultations won broad approval from those representing that community. This estimate assumes that those taxpayers using an agent have no additional compliance costs that they incur other than the fee paid to the agent: that, of course, is very unlikely to be true, meaning that this cost estimate is likely to be understated. £63 million of software costs have then to be added to this sum, making a total of £1,777 million a year, a sum more than £1.6 billion greater than HMRC estimate. This estimate of approximately £1.8 billion is the one I suggest as the most likely minimum cost of MTD to taxpayers. £1.8 billion is almost exactly fifty per cent of the cost of running HMRC a year[xxxiii].

68. On the basis noted in the preceding paragraph there are no conceivable admin burden savings arising for business as a result of MTD. It is notable that the only one identified by HMRC is that 'individual partners in partnerships will no longer have to separately provide HMRC with details of their share of the profits or losses from the partnership.'[xxxiv] Given that most partnership tax returns will be submitted by tax agents and almost all existing tax return preparation software undertake this transcription automatically it might be reasonable to estimate this time saving at, maybe, 2 minutes a year.

69. I can also find no likely ancillary benefits rising to businesses from MTD. As a matter of fact, almost all small businesses of the size that MTD will impact most can be managed on the basis of heuristic key performance indicators that do not require the owner to prepare full accounts to establish very accurate indicators of business performance for management purposes. As such few businesses will secure any real benefit from MTD,

not least because few small business owners have any real understanding of the accounts that are prepared by agents on their behalf at present. In addition existing tax payment methods do also provide most of them with entirely acceptable bases for budgeting likely tax payments. As a result I believe that HMRC's claim that business will benefit from MTD is seriously inaccurate.

70. For reasons of brevity consideration has not been given to the transition costs involved in this process. However, without taking software and hardware costs into account, the likely time to be expended in learning new systems, setting up MTD registration, becoming familiar with new quarter end requirements and, in the case of maybe a million small enterprises, using accounting software for the first time, may be expected to take several days a firm. Assuming that the self employed make just £54 a day on average (i.e. they just achieve the minimum wage) then three days of time engaged in these processes (which appears entirely reasonable given the change in procedure many will have to become accustomed to) would imply cost of at least £956 million, which makes the overall HMRC estimate of £980 million seem decidedly modest when that also covers time spent with accountants, on training fees, software set-up and new hardware, all of which will be additional reasons for this time being expended. It is reasonable to think in that case that the HMRC estimate considerably understates the costs likely to be incurred.

71. It is notable that HMRC has provided no estimate of its own costs of implementing MTD. Since it is inconceivable that there will be none this is a serious omission on their part that needs urgent correction.

72. Even if MTD does save HMRC cost the Public Accounts Committee found recently that for every £1 of saving to HMRC on some aspects of service imposed £4 of additional cost on taxpayers[xxxv]. It would seem very unlikely that MTD will be very different in this regard: whatever benefits HMJRC secures from this process (and at present it is hard to see what they might be) will be suffered many times over in terms of additional costs suffered by taxpayers.

73. In summary, HMRC’s estimate of tax to be recovered as a result of reducing error rates in the tax submissions of those targeted by MTD look to be optimistic in the extreme. If there is, then, any tax to be collected for this reason it may be considerably less than HMRC estimate. HMRC has also failed to consider the possibility that not all errors may be in their favour. HMRC’s estimate of the costs to be imposed on the business community look to be seriously inaccurate and are substantially understated. This is particularly true of ongoing costs and savings, where HMRC estimates that business will make annual savings of £100 million from MTD from 2021-22 tax year onwards whereas this report suggests that annual costs might be approximately £1.8 billion a year. It is extremely difficult in the light of this discrepancy and the implausibility of the estimates implicit in HMRC’s forecasts to think that they have offered an appropriate impact assessment of their proposal to parliament.

Implications of MTD for the tax gap

74. *Please note that for the purposes of this report and to make the presentation of arguments less contentious it has been assumed that HMRC's estimate of the tax gap is correct. The committee is aware that I do not think that this is the case.*

75. HMRC suggest that MTD will only have impact on two component elements of the tax gap. As noted, these are those relating to failure to take reasonable care, which results in a tax loss of £5.5 billion per annum, and errors, which cost £3.2 billion a year[xxxvi]. As noted above, it is not expected that MTD will have the favourable impact on these two tax gaps that HMRC expects. In addition to the computational points already noted the following additional behavioural impacts are also suggested with regard to these two issues:

    a. MTD will require more accounting to be done in a hurry because submission deadlines will be short: more mistakes happen when things are done in a hurry;
    b. Professional firms will be under immense pressure to support clients with MTD returns because these will tend to cluster around the end of calendar quarters. With short submission deadlines quality control in these firms will be much harder to maintain than at present and error rates are likely to rise;
    c. Resentment will discourage commitment to quality;
    d. The threat of HMRC enquiry implicit in HMRC's claims for MTD is now very hollow: most people are now aware that the number of staff available to undertake any checks within HMRC is so small their effective risk of being audited is completely negligible. HMRC expects to reduce the number of staff dedicated to personal tax services by a further 34% by 2020[xxxvii];
    e. Short submission deadline will encourage short cuts;
    f. There will be a very strong incentive to stay below the deadline for submission of three line accounting data. There is already known to be a problem with this threshold with a well above expected number of businesses declaring income of just below the threshold, as also happens with the VAT registration limit and which will now, no doubt, also happen with the MTD threshold. All encourage mis-statement rather than discourage it;
    g. Some taxpayers will opt out of using professional support because of the additional costs of MTD. Given that the NAO has noted that unrepresented taxpayers have a much higher tax return error rate than represented ones the chance of errors increasing rises as a result and software is no substitute for knowledge.

    For all these reasons the tax gap for errors and failure to take reasonable care are likely to increase and not decrease under MTD. Rigorous audit will, however, have to be undertaken to prove this: HMRC's management may have a vested interest in not reporting this data. An Office for Tax Responsibility[xxxviii] could play a key role in monitoring the outcome of this policy.

76. It would appear that MTD is not designed to address other, and potentially more important elements, within HMRC's estimated tax gap, including:

    a. The hidden economy that they suggest costs £6.2 billion pa;
    b. Tax evasion, which costs £5.2 billion a year in their estimate[xxxix];
    c. Criminal attacks which cost £4.8 billion pa;
    d. Non-payment of tax of £3.6 billion pa.

77. If the National Audit Office's findings in 2010, admittedly relating to tax returns from 2004-05, were right (and there is no reason think they are not) and overall patterns of tax return compliance have not changed significantly since then estimates of tax evasion can be prepared based on their data. They suggested that the average under-declaration on tax returns filed by represented taxpayers was around 15 per cent of total actual liabilities, compared with around 35-40 per cent of total liabilities on the returns of unrepresented taxpayers. As noted previously, they suggested that 65% of all tax returns were submitted by professional advisers. £87.1 billion of income was paid with those with earnings from self employment in 2013-14; some 5,620,000 people making declaration[xl]. The average liability was £15,498, albeit this was skewed heavily by those with high earnings. If 65% of these people understated the sum they owed by 15% and 35% by 37.5% then the sum evaded would be £28.3 billion a year. Extending this analysis to small company corporation tax returns, where 78% are submitted by agents, would increase the tax gap by £4.2 billion, delivering a total loss from tax evasion, error and mistakes arising from a lack of care in this sector of maybe £32.5 billion, which is a figure vastly higher than that estimated by HMRC but which would be entirely consistent with estimates of under-declarations of income by such businesses found in the USA where detailed studies have been undertaken[xli]. Such an estimate may be contentious with HMRC, but is consistent with my own research in this area. It would suggest that HMRC under-estimate the SME tax gap by maybe £23 billion pa (calculated by deducting errors and careless mistakes by the SME sector of £4.4 billion and by attributing all tax evasion costs to the SME sector, the latter being a very generous assumption).

78. There is no reason to think that any of these lost revenues will be addressed by MTD. There are however reasons to think that they may increase. This is because the administrative burdens of MTD are likely to drive many small businesses into the shadow economy: many owners of such enterprises will have the ability to supply the goods and services society wants to buy but not to comply with the accounting, IT and administrative burdens of MTD.

79. Anecdotal evidence provided from a number of sources also suggested that many older self-employed taxpayers might abandon their businesses, or significantly reduce their scale, in the face of MTD requirements. MTD may not just impose substantial additional cost on the business community but may actually shrink its size.

80. In this case questions has to be asked as to why HMRC are pursuing a policy that appears to have little or no realistic prospect of raising tax revenue when appropriate

assumptions are used to estimate its revenue impact and which will impose substantial costs (maybe £1.8 billion) on the small business sector.

81. It may be appropriate to note at this juncture that Adam Smith identified four maxims with regard to the management of taxation in 1776 in The Wealth of Nations[xlii]. In summary these were that tax should be equitable, certain, convenient and efficient. There is no available evidence that MTD is equitable, convenient or efficient. The only thing that appears certain about it is that it will impose considerable additional cost on taxpayers.

82. This then gives rise to a series of conclusions:

    a. The tax gap may not be reduced by MTD;
    b. The tax gap may actually be increased by MTD;
    c. The size of the small business economy may be reduced by MTD;
    d. The scale of the burden that MTD will impose on small business is disproportionate to any tax gains to HMRC;
    e. MTD is not an equitable, convenient or efficient tax measure;
    f. MTD is wholly inconsistent with the stated aims of a government seeking to reduce the administrative burdens on business.

Brief comparison of MTD and the existing self-assessment tax system

83. Under the existing self assessment tax system:

    a. Taxpayers submit a return once a year;
    b. Most have ten months to do so following their year end allowing them to undertake the necessary tasks at a time convenient to their businesses at minimum cost;
    c. Taxpayers have a digital tax account;
    d. Taxpayers do, after their first year of trading, always have up to date estimates of their tax liability which they may alter if they know that their circumstances have changed;
    e. Can use their annual accounts prepared for other purposes e.g. to support borrowing applications, to support their tax return;
    f. Can (and most do) make digital tax returns.

    In summary, the system is efficient, timely and imposes just about the minimum cost possible to achieve its objectives.

84. Under MTD:

a. Taxpayers will have to make at least five submissions of data a year. Four of these will be MTD data and one will be the equivalent of the filing of the accounts that support the existing tax return;
b. Taxpayers may submit wholly misleading and incomplete data to HMRC on which tax estimates will be based because:
    i. Cash flow accounting cannot present a true and fair view of the income of a business or company for a period, which is why it is illegal for most companies to use it in the UK;
    ii. Cash flow accounting can produce highly erratic and potentially contradictory data on business performance that could, if not properly appreciated by HMRC give rise to wholly unnecessary tax enquiries;
    iii. Some key tax data will be missing from returns made. For example MTD returns will not apparently include information on capital allowances, pensions paid and other reliefs that might be claimed which may have a material impact on final tax liabilities owing.
c. Taxpayers may seriously overpay tax on account for the reasons noted in the previous paragraph.

85. MTD does as a result:

a. Potentially impose inappropriate and potentially seriously misleading accounting methods on taxpayers that may be seriously harmful to their business interests to suit the requirements of HMRC. Business failures as a result of the use of inappropriate accounting data are likely to increase as a result;
b. Potentially threaten the cash flows and so viability of some small businesses in the UK;
c. Threaten the credibility of small business accounting in the UK;
d. Potentially harm UK economic performance as a result.

It is hard to think of a policy more antithetical to the culture of enterprise in the UK than MTD as HMRC propose to impose it.

Appendix 1

Necessary tasks likely to be required to be undertaken to complete an MTD return for a simple business each quarter

Please note that basic book-keeping that would be required to prepare existing year end accounting obligations of a small business are excluded from the following lists as they would have to be undertaken anyway. The tasks noted are those additional activities that might need to be undertaken at each quarter end to ensure that a taxpayer makes a correct

MTD declaration. They will be necessary as there are bound to be penalties imposed for false declarations. All these tasks are, then, additional to those now required by law.

1. Check cut off for all transactions i.e. make sure a strict allocation to quarters has taken place;
2. Reconcile bank accounts to ensure completeness and correct period end cut off;
3. Check sales ledger completeness and closing debtors to ensure income is appropriately stated and make necessary adjustments e.g. for bad debts if using an accruals accounting method;
4. Check the purchase ledger and outstanding creditors and make necessary adjustments;
5. Accrue period end expenses;
6. Calculate period end prepayments;
7. Count or estimate value of stock and work in progress;
8. Estimate depreciation;
9. Make adjustments for:
    a. Private use of car and other assets;
    b. Use of house as office;
    c. Stock taken as drawings.
10. Ensure that the resulting accounts make sense and correct for errors;
11. Check that drawings are appropriately recorded in a self-employment;
12. Check digital entries prior to submission to HMRC;
13. Log on and submit to HMRC;
14. Check resulting communications from HMRC;
15. Act in accordance with HMRC instructions e.g. re adjusted payments owing.

Even in the case of a simple business these tasks may well take half a day to complete. They may take much longer in a larger business.

Appendix 2

About the author

Richard Murphy is a UK chartered accountant and political economist. He was appointed as Professor of Practice in International Political Economy at City, University of London in September 2015.

Richard was senior partner of a practicing firm of chartered accountants and director of a number of entrepreneurial companies before becoming one of the founders of the Tax Justice Network in 2002. He now directs Tax Research UK in addition to his duties at City, University of London and writes, broadcasts and blogs extensively, the latter at http://www.taxresearch.org.uk/Blog/ .

During the summer of 2015 he was widely credited with creating 'Corbynomics' and is the creator of the idea now known as People's Quantitative Easing. He is not a member of any political party.

Richard's latest book is 'Dirty Secrets: How tax havens destroy the economy' published by Verso in February 2017.

He was previously the author of 'The Joy of Tax', Bantam, September 2015, and 'The Courageous State', Searching Finance, 2011. Richard is joint author of 'Tax Havens, The True Story of Globalisation', Cornell University Press, 2010.

Richard created the country-by-country reporting concept and has been credited with creating much of the debate on tax gaps in the UK and Europe. He also defined the term 'secrecy jurisdictions', now widely used in debates on offshore. He has been involved in many of the stories on corporate tax abuse that have made headlines in recent years.

Richard developed the idea of the Fair Tax Mark and is technical director of that accreditation scheme.

In 2012 the Association of International Accountants gave Richard their award for an outstanding contribution to the accountancy profession. He was named the seventh most influential person in international tax by the International Tax Review in 2013. In 2015 the Sheila McKechnie Foundation named him as their Economic Justice Campaigner of the Year.

Endnotes

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